

General Information Letter: Taxpayer's sales of services are sourced using the income producing activity and cost of performance rules.

September 12, 2005

Dear:

This is in response to your letter dated September 7, 2005 in which you request a general information letter. Your letter reads as follows:

COMPANY ("COMPANY"), an assumed name for purposes of this general information letter, is a Delaware corporation with its commercial domicile in New Jersey. COMPANY provides prescription benefit management services and programs. COMPANY does business and files income tax returns in Illinois and in various other states throughout the United States. The programs and services help COMPANY's clients, such as insurance companies ("Clients" or "Insurance Cos."), reduce costs and enhance the quality of the prescription drug benefits that are provided to Insurance Co.'s members ("Patients"). COMPANY accomplishes this objective primarily by managing prescriptions filled through its national network of retail pharmacies and its own mail order pharmacies, negotiating competitive rebates and discounts from pharmaceutical manufacturers, and obtaining competitive discounts from retail pharmacies.

COMPANY's revenues, as reported on its audited financial statements and federal income tax returns, are generated from the following sources:

- 1) Mail-order sales of prescription drugs (the "Mail-Order Business");
- 2) Amounts received from Insurance Cos. for drugs picked up at network pharmacies (the "Retail Business"); and
- 3) Dispensing fees and rebates.

The Mail-Order Business

COMPANY purchases prescription drugs from unrelated drug wholesale and pharmaceutical companies and maintains an inventory from which it ships the drugs to the Patients. COMPANY is paid by the Insurance Cos. for amounts exceeding the co-payments paid by the Patients.

COMPANY believes that this portion of its business is the selling of tangible personal property and will compute the numerator of its receipts fraction based upon the destination to which the drugs are shipped. This is not the subject of this general information letter request.

The Retail Business

COMPANY contracts with Clients to provide prescription drugs to Patients through COMPANY's network of contractually affiliated retail pharmacies. COMPANY has contractual relationships with more than 50,000 independent and chain retail pharmacies that have agreed to participate in its program. The retail pharmacies are independent contractors and are not agents of COMPANY. COMPANY negotiates discount rates and prices with the retail

pharmacies. The retail pharmacies fill prescriptions from their own inventories. Neither title nor possession to the drugs is transferred to COMPANY

The retail pharmacies maintain online contact with COMPANY to process the prescriptions and COMPANY confirms the Patient's eligibility, determines the co-payment and conducts concurrent drug interaction/utilization reviews. These services are rendered outside Illinois.

COMPANY records the amounts it receives from Insurance Cos. as gross revenues and the amounts paid to the retail pharmacies as cost of sales on its audited financial statements and federal income tax returns.

Dispensing Fees and Rebates

COMPANY's contracts with its Clients provide that COMPANY will receive a dispensing fee and/or an administrative fee for each prescription filled. COMPANY in turn pays the retail pharmacies a similar fee for each prescription filled.

COMPANY also receives rebates from pharmaceutical manufacturers. The rebates are predominantly based on a percentage of aggregate dollar value of a particular drug that is dispensed (via mail order and retail pharmacies). The contracts generally provide for two types of rebates:

- 1) Formulary rebates, which are based upon inclusion of the manufacturer's products on the approved list of drugs used by the Insurance Cos.; and
- 2) Performance based or market share rebates, which are based upon COMPANY's achievement of targeted sales volume in certain markets.

COMPANY generally shares a portion of the rebates with Clients and accounts for its rebates by reducing cost of sales by the gross rebates received and reducing sales by the rebates given to Clients.

ISSUES FOR OUR GENERAL INFORMATION LETTER REQUEST

- I. For purposes of computing the sales factor and sourcing the receipts of the Retail Business, will COMPANY be considered a seller of tangible personal property or a service provider?
- II. If COMPANY is considered a service provider in Illinois with respect to its Retail Business, should COMPANY apply the income producing activity test to determine how much of its receipts from the Retail Business should be sourced to Illinois?
- III. If COMPANY is required to use the income producing activity test, will the activities performed by the independent retail pharmacies be included in the analysis for determining how much of COMPANY's receipts generated from its Retail Business should be sourced to Illinois?

DISCUSSION & ANALYSIS

I. Service Provider vs. Seller of Goods.

We are not aware of any published guidance in Illinois that addresses the issue of whether COMPANY, in conducting its Retail Business, is a seller of tangible personal property or a service provider. However, based on COMPANY's activities in performing its contractual obligations to its Clients, we believe that COMPANY is a service provider for purposes of computing the sales fraction and sourcing the receipts of its Retail Business. The following factors would support a finding that COMPANY is a service provider for its Retail Business:

1. COMPANY does not take title or possession to any drugs that are dispensed by the independent pharmacies.
2. COMPANY is engaged by its Clients to manage prescription benefit programs. COMPANY achieves this objective by contracting with local pharmacies to participate in the network and negotiating competitive rebates and discounts from pharmaceutical companies so that the cost to its Clients is minimized.

Since COMPANY does not take title or possession to any drugs dispensed in its Retail Business and its core function is to manage prescription benefit programs for its Clients, we believe that COMPANY is performing a service in its Retail Business.

II. Sourcing of Receipts.

Section 304 of the Illinois Income Tax Act (35 ILCS 5/101 et seq.) provides a general framework for apportioning a taxpayer's business income to Illinois using a sales factor. The sales factor is defined as a fraction, the numerator of which is Illinois sales during the taxable year and the denominator of which is total sales of the taxpayer everywhere. 35 ILCS 5/304(a)(3). Regulation 100.3370(b) further provides that the denominator of the sales factor shall include the total gross receipts derived by the person from transactions and activity in the regular course of its trade or business. Accordingly, all of the gross receipts generated by COMPANY from its Retail Business, including the amounts it receives from the Insurance Cos., will be included in the denominator of COMPANY's sales factor and COMPANY's sales factor denominator will approximate its receipts requested on its audited financial statements and on its federal income tax returns.

In computing the numerator of the sales factor for service providers, Section 304(a)(3)(C) provides that:

Sales, other than sales of tangible personal property and intangible personal property, are in this State if:

- (i) the income producing activity is performed in the State; or
- (ii) the income-producing activity is performed both within and without

this State and a greater proportion of the income-producing activity is performed within this State, based on performance costs.

If COMPANY is performing a service in its Retail Business, then COMPANY should source its receipts pursuant to §304(a)(3)(C) based on where the income producing activity occurs.

III. Income-Producing Activity.

The term "income-producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the person in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. 86 Ill. Admin. Code § 100.3370(c)(3)(A). Such activity does not include transactions and activities performed on behalf of a person, such as those conducted on its behalf by an independent contractor. *Id.*

Accordingly, only the activities of a taxpayer and its employees may be considered income-producing activity of the taxpayer. Activities of other third parties may not be considered income-producing activities of the taxpayer. *Ill. Income Tax Letter. Rul. IT 01-0009 (Sept. 15, 2001)*

The retail pharmacies are independent contractors and not employees of COMPANY. As such, these activities fall directly within the language of 86 Ill. Admin. Code § 100.3370(c)(3)(A) as "activities performed on behalf of a person." Based on the regulations, the activities conducted by the pharmacies, pursuant to contracts with COMPANY, should not constitute income-producing activities of COMPANY and should not be attributed to COMPANY.

Department's Response

According to the Department of Revenue ("Department") regulations, the Department may issue only two types of letter rulings: Private Letter Rulings ("PLR") and General Information Letters ("GIL"). The regulations explaining these two types of rulings issued by the Department can be found in 2 Ill. Adm. Code §1200, or on the website <http://www.tax.illinois.gov/LegalInformation/regs/part1200>. We are responding with a GIL because you are requesting this type of a ruling. GILs are designed to provide background information on specific topics. GILs, however, are not binding on the Department.

You are requesting information relating to the determination of the proper sales factor for your retail business. Pursuant to the Illinois Income Tax Act ("IITA," 35 ILCS 5/101 *et seq.*) section 304(a)(3)(A), the sales factor is defined as "a fraction, the numerator of which is the total sales of the person in this State during the taxable year, and the denominator of which is the total sales of the person everywhere during the taxable year."

The first issue mentioned in your letter is to determine whether COMPANY will be considered a seller of tangible personal property or a service provider for purposes of computing the sales factor. The Illinois Department of Revenue Regulations ("Regulations," 86 Ill. Admin. Code 100 *et seq.*) section

100.3370(a)(1) provides that the term “sales” for the purposes of the sales factor means all gross receipts from transactions and activity in the regular course of the taxpayer’s trade or business. According to Regulation 100.3370(a)(1)(A), if COMPANY is considered a seller of tangible personal property, “sales” would include

all gross receipts from the sales of such goods or products (or other property of a kind which would properly be included in the inventory of the person if on hand at the close of the tax period) held by the person primarily for sale to customers in the ordinary course of its trade or business.

Regulation 100.3370(a)(1)(C) states that if COMPANY is considered a service provider, “sales” would include “the gross receipts from the performance of such services including fees, commissions, and similar items.”

Your letter states that in completing its retail business, COMPANY hires independent contractors to fill prescriptions from the independent contractors inventories, and that the independent contractors ship the drugs directly to the patients. At no time does COMPANY take title or possession of the drugs that are sent to patients by the independent contractors. COMPANY processes prescriptions, confirms patients’ eligibility and determines patient co-payments via online contact with the independent contractors. Because COMPANY does not have an inventory and is not selling goods or products with its retail business, COMPANY is considered a service provider for purposes of determining the Illinois sales factor for the sales from its retail business.

As a service provider in its retail business, COMPANY is required to follow IITA section 304(a)(3)(C) which provides the sourcing rule for sales factor purposes for gross receipts from sales other than sales of tangible personal property:

Sales, other than sales of tangible personal property and intangible personal property, are in this State if:

- (i) the income-producing activity is performed in the State; or
- (ii) the income-producing activity is performed both within and without this State and a greater proportion of the income-producing activity is performed within this State, based on performance costs.

Pursuant to the above, COMPANY must apply the income producing activity test to determine how much of its receipts from the retail business should be sourced to Illinois.

The last issue raised in your letter asks whether activities performed by the independent retail pharmacies will be included in the analysis for determining how much of COMPANY’s receipts generated from its retail business should be sourced to Illinois. The answer lies in the definition of income-producing activity found in Regulation 100.3370(c)(3)(A):

Income producing activity defined. The term “income producing activity” applies to each separate item of income and means the transactions and activity directly engaged in by the person in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Such activity does not include transactions and activities performed on behalf of a

person, such as those conducted on its behalf by an independent contractor.

Your letter states that the retail business of COMPANY uses independent contractors (retail pharmacies) to fill patient prescriptions. You also state that COMPANY performs all its retail business services outside of Illinois. In your letter you cite to IT-01-0009-PLR (09/15/01) to support your position that the activities of the retail pharmacies should not constitute income-producing activities of COMPANY and should not be attributed to COMPANY. You are correct.

According to page 14 of IT-01-0009-PLR, the Regulation definition of income producing activity means that

only the activities of the taxpayer and the taxpayer's employees may be considered income-producing activity of the taxpayer. Activities of other third parties may not be considered income-producing activity of the taxpayer. Thus, a taxpayer without property or employees in Illinois at any time would not be conducting income producing activities within Illinois.

Based on the above, the activities performed by the independent retail pharmacies will not be included in the analysis for determining how much of COMPANY's receipts generated from its retail business should be sourced to Illinois.

Your letter does not bring up the issue of whether COMPANY should include any of its gross receipts in its Illinois sales factor numerator, nor have you provided information necessary to properly discuss that issue. Accordingly, this letter does not address this matter.

As stated above, this is a general information letter which does not constitute a statement of policy that either applies, interprets or prescribes tax law. It is not binding on the Department. Should you have additional questions, please do not hesitate to contact our office.

Sincerely,

Heidi Scott
Staff Attorney -- Income Tax